Supreme Court, U.S.
FILED
APR 1 1999
OFFICE OF THE CLERK

No. 98-1058

IN THE

Supreme Court of the United States

OCTOBER TERM, 1998

ROBERT D. POTTS,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

LOUIS A. CRACO
Counsel of Record
787 Seventh Avenue
New York, New York 10019
(212) 728-8000

Attorney for Amicus Curiae American Institute of Certified Public Accountants

RICHARD I. MILLER
General Counsel
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, New York 10036
(212) 596-6200

Of Counsel:

KRISTIN BRANSON
WILLKIE FARR & GALLAGHER
787 Seventh Avenue
New York, New York 10019
(212) 728-8000

1498

QUESTION PRESENTED

Whether Petitioner had fair notice of the standards for concurring review of a public company audit when he performed concurring reviews of audits of Kahler Corporation ("Kahler") in 1989 and 1990, or whether the SEC and the Eighth Circuit retroactively applied standards previously unarticulated and undefined by any authority in sanctioning Petitioner under SEC Rule 2(e)?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
PRELIMINARY STATEMENT	1
INTEREST OF THE AICPA AS *AMICUS CURIAE*	1
THE DECISION BELOW	4
REASONS FOR GRANTING THE WRIT	4
I. THE ISSUE PRESENTED IS OF GREAT IMPORTANCE TO ACCOUNTING FIRMS PRACTICING BEFORE THE SEC AND TO THEIR CLIENTS.	4
II. THE COURT SHOULD REVIEW THE DECISION BELOW AND REQUIRE THE SEC TO APPLY NEWLY ARTICULATED STANDARDS FOR ACCOUNTANTS PROSPECTIVELY, NOT RETROACTIVELY.	6
CONCLUSION	11

TABLE OF AUTHORITIES

Page

Cases:

Carter, Securities Act Release No. 17597, Fed. Sec. L. Rep. (CCH) (Feb. 28, 1981) 6

Lester Witte & Co., Exchange Act Release No. 17,423, ASR No. 285, [1937-1982 ASR Transfer Binder] Fed. Sec. L. Rep. (CCH) (Jan. 7, 1981) 9

SEC v. Thornton, Litigation Release No. 11,263, AAER No. 118, [1982-1987 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) (Oct. 16, 1986) 9

Stephen O. Wade, Exchange Act Release No. 21,095, AAER No. 32, 30 S.E.C. Docket 972, 1984 WL 53374 (June 25, 1984) 9, 10

Upton v. SEC, 75 F.3d 92 (2d Cir. 1996) 6

Rules:

Securities and Exchange Commission Rule 2(e) ... i

United States Supreme Court Rule 37.2 1

Other Authority:

AICPA, SECPS, Appendix E (October, 1988) 3, 8

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "AICPA") submits this brief as *amicus curiae*, pursuant to Rule 37.2 of the Rules of this Court, in support of Petitioner with the written consent of the parties.[1]

INTEREST OF THE AICPA AS *AMICUS CURIAE*

The AICPA is the national organization of the certified public accounting profession, with more than 340,000 members. It seeks to promote high professional standards of practice, and has come to be accepted by the profession, the public, and the SEC as an authoritative source of standards and procedures in its field. In particular, the AICPA develops the standards and procedures that govern the conduct of audits by certified public accountants collectively known as "generally accepted auditing standards" ("GAAS").

The AICPA also established the Division for Firms and its SEC Practice Section ("SECPS") in 1977, as a response to public and congressional concern about the profession's oversight of public company audits. The AICPA, but not the SEC, requires firms whose owners are members of the AICPA and that audit public companies to be members in good standing of the SECPS. The AICPA's SECPS requires member firms to comply with certain guidelines promulgated by the SECPS and overseen by an independent Public Oversight Board.

---

1. The letters of consent have been filed with the Clerk of the Court. No counsel for any party to this action authored this brief in whole or in part. No person or entity other than the AICPA, its members, and its counsel made a monetary contribution to the preparation or submission of this brief.

The AICPA's SECPS guidelines promote compliance with an array of prophylactic practices designed to provide heightened assurance that audits will be properly carried out. Those guidelines speak in general terms, and leave much discretion in implementation to individual SECPS member firms. This flexibility was not accidental, but was meant by the AICPA to balance several sets of competing, valid interests. One was to avoid too-rigid a set of standards so that smaller firms would not find it prohibitive to engage in audits of public companies. Another was to balance the need for heightened prophylactic measures with the need to avoid dilution of the undelegable responsibility of the partner-in-charge of the audit for the audit's compliance with GAAS.

In keeping with these goals, the SECPS published guidance as to the attributes of a concurring review, but left it to individual firms to provide concurring reviewers with specific guidelines. A concurring review is not intended to replicate or replace the audit, but only to provide "additional assurance" that the audit complies with GAAS. The SECPS guidelines emphasized that the concurring reviewer did not displace the role of the partner-in-charge:

> The purpose of the concurring review requirement is to provide additional assurance that (1) the financial statements of SEC engagements . . . are in conformity with generally accepted accounting principles or other comprehensive basis of accounting and (2) the firm's report thereon is in accordance with generally accepted auditing standards. Performance of a concurring review does not relieve the partner in charge of the

> engagement from final responsibility for the issuance of the firm's audit report. . . .

AICPA, SECPS, Appendix E (October, 1988). Prior to the publication of the SECPS guidelines, no concurring review was required, or even suggested, for any audit. The only authority that requires a concurring review is the SECPS, which applies only to AICPA members. The SEC itself does not require firms that audit public companies to be AICPA or SECPS members.

The AICPA and its members have a strong interest in this Court's review of the decision below. The decision measured Petitioner's actions in performing a concurring review by standards far beyond those of the SECPS. The only generally applicable guidance was provided by the SECPS, and the SEC has not argued that Petitioner failed to comply with SECPS guidelines, or with his firm's internal compliance standards for a concurring review. In its sanction of Petitioner, the SEC created a standard not previously articulated by the SEC, the AICPA, or Petitioner's firm, and applied it retroactively.

The Eighth Circuit's decision has serious ramifications for the proper implementation of both the SECPS guidelines and GAAS. The retroactive application of newly announced concurring review standards will sow confusion as to the proper role of the concurring reviewer. Concurring reviewers cannot ascertain what the requirements of their role are, and cannot perform their duties without the possibility of running afoul of SEC requirements not yet announced. The result, as concurring reviewers expand their role in an effort to protect themselves from career-destroying SEC sanctions, will be the concurring reviewer's encroachment upon the authority of the partner-in-charge. This will prohibitively raise costs and dilute accountability for the audit report. The decision below is not only erroneous but counterproductive.

In order to avoid unnecessary duplication, the AICPA defers to the Petitioner's recitation of the Statement of the Case.

THE DECISION BELOW

The Eighth Circuit held that Petitioner's conduct in reviewing and "signing off" on Kahler's audits for the years 1988 and 1989 was reckless. (Pet. App. at A-5.) The court further held that Petitioner's due process argument failed because Petitioner had adequate notice of the SEC's standards of professional conduct for concurring reviewers, finding that "the Commission evaluated Pott's conduct in light of the well-established norms of the accounting profession, collectively referred to as GAAP and GAAS." (Pet. App. at A-6, A-7.)

REASONS FOR GRANTING THE WRIT

I. THE ISSUE PRESENTED IS OF GREAT IMPORTANCE TO ACCOUNTING FIRMS PRACTICING BEFORE THE SEC AND TO THEIR CLIENTS.

In 1989 and 1990, when Petitioner conducted his concurring review of the Kahler audits, a concurring review was subject only to the general guidelines provided by the SECPS, and to internal guidelines created by the reviewer's firm. Under GAAS and the SECPS, the partner-in-charge had sole responsibility for ensuring that the audit complies with the requirements of GAAS and for so stating in the audit report, and that responsibility could not be delegated or shared.

In sanctioning Petitioner, the SEC and the Eighth Circuit announced and applied a brand new set of standards for concurring reviewers, expanding their duties to include those of the partner-in-charge. Not only does this violate Petitioner's right to due process, it has a broad impact on accountants and the accounting professions.

Given such retroactive application of new standards, reviewers may only be able to protect themselves from sanctions if they re-do the audit, covering all possible bases for SEC dissatisfaction. The result is not a concurring review as intended by the AICPA, but a second partner-in-charge. This replication of work prohibitively overburdens the concurring reviewers, their firms, their clients who must pay for the redundant work, and those firms whose resources make such an endeavor impractical and are thus foreclosed from auditing public companies.

The retroactive application of new standards may also chill the process by which the AICPA and other private, voluntary organizations set standards for their members. Such standards are carefully crafted by the AICPA and other voluntary organizations for the purpose of improving the services offered by their members. When the SEC alters these standards without notice by adding retroactive content, voluntary standards can become a burden, rather than a benefit, both to members and to their clients. Private organizations may become reluctant to create any new standards when their content and application become unpredictable in the hands of the SEC.

Finally, the decision below undermines the most important single safeguard of the integrity of the audit process — the undiluted authority and responsibility of the CPA partner-in-charge who signs the audit opinion.

II. THE COURT SHOULD REVIEW THE DECISION BELOW AND REQUIRE THE SEC TO APPLY NEWLY ARTICULATED STANDARDS FOR ACCOUNTANTS PROSPECTIVELY, NOT RETROACTIVELY.

The SEC has acknowledged that a professional is entitled to notice of applicable regulatory standards if such standards are to be used as the basis for sanctions:

> [E]lemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper.

Carter, Securities Act Release No. 17597, Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981), at 84,173; *see Upton v. SEC*, 75 F.3d 92, 96 (2d Cir. 1996) (court cannot defer to the SEC's interpretation of its rules if doing so would penalize an individual who has not received fair notice of a regulatory violation).

The SEC, nevertheless, sanctioned Petitioner based on standards never previously articulated by the AICPA or the SEC, and, in fact, contradicted by the SECPS.

The Eighth Circuit found that Petitioner was on notice of the standards applied by the SEC because GAAS requires that: (a) an auditor's opinion must have a basis in specific evidence; (b) an auditor must maintain an appropriate level of professional skepticism; (c) an auditor who suspects a

material misstatement in the financial report must extend the audit accordingly; and (d) the more important the item, the stronger must be the grounds for the auditor's opinion. (Pet. App. at A-6.) All of this, however, says nothing as to the specific conduct required of a concurring reviewer. It does not define what kind of evidence suffices, what level of skepticism is "appropriate," how far the concurring review must be extended, or how strong grounds for a concurrence must be.[2] Each of these requirements is measured by the role of the accountant in a specific audit, and in 1989 and 1990, the duties of a concurring reviewer were defined only by the SECPS guidelines, which strictly limited the concurring reviewer's role:

> The concurring reviewer's responsibilities should include reading the financial statements and the firm's report thereon and making an objective review of significant accounting, auditing or reporting considerations. *Such review should . . . include discussions with the partner-in-charge of the engagement* and review of selected working papers. *The extent of working paper review is a professional judgment which has to be made by*

---

2. The SEC majority more specifically asserted that Petitioner, as concurring reviewer, was required by GAAS to: "probe" and challenge the partner-in-charge as to the veracity of his statements; ask the partner-in-charge for documentary evidence supporting his statements; question a document prepared by a senior manager of the firm verifying a valuation; and conclude that formal audit committee minutes in the Top File were insufficient evidence. (Pet. App. at A-24 - A-30.) GAAS includes no such requirements for concurring reviewers.

> *the reviewer* and will vary with the particular circumstances of each engagement.

AICPA, SECPS, Appendix E (October, 1988) (emphasis added). The SEC has not argued, and the court below has not found, that Petitioner failed to comply with these guidelines. Instead, Petitioner apparently was sanctioned for failing, without basis, to disbelieve the statements of the partner-in-charge — a new requirement imposed by the SEC.

One of the few specific steps the SECPS mandated is "discussions with the partner-in-charge." The misconduct found by the SEC majority consisted of Petitioner's failure to take additional steps after the partner-in-charge had investigated, with Petitioner's supervision, their concerns, and had explained to Petitioner that he was satisfied. The additional steps required by the court below would impose upon Petitioner the responsibility of the partner-in-charge — a transfer of responsibility that was specifically prohibited by the SECPS:

> For the concurring review to be an objective review of material accounting, auditing or reporting issues, the concurring reviewer ordinarily should not assume any of the responsibilities of the partner-in-charge of the engagement. Similarly, the concurring reviewer should not have responsibility for any segment of the engagement.

AICPA, SECPS, Appendix E (October, 1988).

To be sure, if matters arise in the concurring review demonstrating that the concurring reviewer could not accept the judgment of the partner-in-charge, then the concurring reviewer would be obliged to extend the review. Under the SECPS guidelines, the extent of the concurring reviewer's

review of the evidence obtained was explicitly left to his professional judgment in the circumstances, and the general standards applicable to all accountants' services require the accountant to exercise due professional care in performing duties. Barring circumstances indicating that the judgment of the partner-in-charge is impaired, however, the insistence that Petitioner should without basis have obtained audit evidence beyond the assurances of the partner-in-charge or the senior managers of his firm illustrates the imposition, without notice, of the responsibility of the audit engagement team upon the concurring reviewer. Petitioner's duties were those of a concurring reviewer, not a partner-in-charge.

The Eighth Circuit relied on three cases to support its finding that Petitioner was on notice of concurring reviewer duties beyond those stated by the SECPS. None of these was contested, and analysis of them emphasizes the lack of defined standards for a concurring review.

In *Lester Witte & Co.*, Exchange Act Release No. 17,423, ASR No. 285, [1937-1982 ASR Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,307, at 62,865 (Jan. 7, 1981), the SEC did not sanction the concurring reviewer, even though it found the concurring review inadequate. Rather, the SEC sanctioned only the firm and the partner-in-charge, emphasizing that the partner-in-charge "bears responsibility for the audit deficiencies which occurred." *Id.* at 62,865-66. *Lester Witte* contradicts, rather than supports, the assertion that Petitioner's conduct could be measured against any existing standards.

Neither *SEC v. Thornton*, Litigation Release No. 11,263, AAER No. 118, [1982-1987 AAER Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,518 (Oct. 16, 1986), nor *Stephen O. Wade*, Exchange Act Release No. 21,095, AAER No. 32, 30

S.E.C. Docket 972, 1984 WL 53374 (June 25, 1984), offers any standard for the conduct of a concurring reviewer. The cases cited by the Eighth Circuit, as the opinion's parentheticals note, state in general terms that the concurring reviewer's role is to review the audit with the purpose of detecting violations of GAAP and GAAS. These cases, and the Eighth Circuit's review of them, however, shed no light on the question here: To what lengths was a concurring reviewer required to go in seeking to detect violations of GAAP and GAAS? There is no authority in either the professional literature or SEC cases for requiring Petitioner, as a matter of practice, to disbelieve the statements of the partner-in-charge, or to commence an independent investigation of the bases for the audit opinion. Indeed, the cases cited make it clear that the SEC engaged in improper retroactive application of newly-announced standards.

CONCLUSION

For the foregoing reasons, the AICPA respectfully urges this court to grant the Petition to review the decision of the Eighth Circuit Court of Appeals.

Respectfully submitted,

LOUIS A. CRACO
Counsel of Record
787 Seventh Avenue
New York, New York 10019
(212) 728-8000

Attorney for Amicus Curiae
American Institute of Certified
Public Accountants

RICHARD I. MILLER
General Counsel
AMERICAN INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS
1211 Avenue of the Americas
New York, New York 10036
(212) 596-6200

Of Counsel:

KRISTIN BRANSON
WILLKIE FARR & GALLAGHER
787 Seventh Avenue
New York, New York 10019
(212) 728-8000

Dated: April 1, 1999